Tax News Flash

- Transfer Pricing

July 2023

Samjong KPMG Transfer Pricing & Customs Service Group provides readers with Transfer Pricing related recent local tax issues and trends.

This newsletter is a monthly publication of Samjong KPMG Transfer Pricing & Customs Service Group. If you need more detailed explanation, please feel free to contact key contacts or Tai-Joon Kim for transfer pricing matters and Tae-Joo Kim for customs matters.

The following is a recent Korea's tax ruling in relation to transfer pricing

The expenses borne by the taxpayer is pursuant to a cost sharing agreement and it is appropriate not to deem such expenses as a royalty expense.
<Decision 2022Nu36010, 2022.12.14>

Background

- The taxpayer had a license agreement and paid a royalty for the use of intangibles to the affiliates within the Group. On November 1st of 2013, the taxpayer entered into a cost sharing agreement with an affiliate located in France (hereinafter, 'France Entity') for the R&D of glass manufacturing technology. In accordance with the cost sharing agreement, France Entity charged the taxpayer the allocated R&D costs for the period from November 2013 and August 2018, and the taxpayer made the payment for the allocated costs to France Entity. In accordance with Article 12(2) of the Korea-France tax treaty, the taxpayer deemed the payment as royalty, withheld the 10% of the payment and paid withholding tax.

- On October 31st of 2018, the taxpayer filed a tax return amendment to relevant tax office in order to request that the expense was a cost pursuant to the cost sharing agreement rather than a royalty payment. However, the tax office denied the request. Subsequently, the taxpayer filed a request for an appeal to the Tax Tribunal in Korea. The Tax Tribunal rejected the taxpayer's request.

- Accordingly, the taxpayer took the case to the Seoul Administrative Court, and the Court consequently decided to cancel the tax office's denial for the taxpayer's request for the tax return amendment in the first trial (Seoul Administrative Court 2022.01.11. Decision 2020Guhap82918).

Tax Office's (Defendant) Claims

- In accordance with Paragraph 1 of Article 14-3 of the Enforcement Decree (hereinafter, 'ED') of the Law for the Coordination of International Tax Affairs (hereinafter, 'LCITA'), the key factor of a cost sharing agreement is the 'expected benefits' such as 'decrease in cost' or increase in sales. However, the agreement applies an allocation key of 'net sales' rather than expected benefits and therefore it cannot be categorized as a cost sharing agreement.

- The taxpayer previously deemed the expense as a royalty expense and paid withholding tax and did not submit the tax form of 'the cost sharing statement' pursuant to Article 14-6 of ED of LCITA in filing its tax return. Accordingly, it is difficult to judge that the agreement was made for the purposes of cost sharing.

- In the case that the taxpayer uses the existing intangibles that the France Entity currently owns for R&D purposes, the expense is a royalty that is excluded from the arm's length cost sharing amount in accordance with Paragraph 2 Article 14-2 of ED of LCITA. Moreover, even if the taxpayer uses the intangibles for business operation, it is not related to the development of new intangibles, and the expense would substantially be characterized as royalty expense.

Taxpayer's (Plaintiff) Claims

- 'Net sales' was applied as a measure of expected benefits and appropriately calculated the cost sharing amount to be allocated to the taxpayer. Even if the allocation key for expected benefits were not appropriately applied, the tax office only could challenge whether the tax paid was under or overreported. Thus, the expense cannot be deemed as a royalty expense.

- Although Article 14-6 of ED of LCITA stipulates that the cost sharing statement must be submitted for the deductibility of expenses, the LCITA does not regulate that the submission of the cost sharing statement is a prerequisite to form the cost sharing agreement.

- The expense is the allocation of costs incurred for the jointly developed intangibles and does not include the use of intangibles.

Court Decision

It was ruled that the expense is a cost sharing expense rather than a royalty expense in consideration of the below matters.

- Application of net sales as an allocation key for expected benefits is appropriate considering that:

  (1) the R&D union consists of the France Entity which operates as a coordinator and the Group's affiliates that operate glass businesses,
  (2) the economic benefits of using the intangibles consisting of joint know-how from the R&D union will be reflected in the overall sales,
  (3) the taxpayer continued to use patents from the R&D union in accordance with the license agreement in their glass manufacturing business operation

- The taxpayer was not compulsorily required to submit the cost sharing statement for the transaction to constitute as a cost sharing agreement.

- As the taxpayer contracted into the cost sharing agreement as a new entrant, it should have paid the royalty to existing entrants for the use of existing intangibles separately. However, simply such circumstances do not prove that the agreement under review is not a cost sharing agreement.

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